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THE DYNAMICS OF GLOBAL-DOMESTIC INSTITUTIONAL INTERACTION IN POSTCOMMUNIST RUSSIA AND ELSEWHERE

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Abstract: This study argues for the need to better integrate the role of international factors, specifically global financial institutions, in order to understand the roots of institutional failures in some post-communist countries, including Russia. It explores the differential nature of policy challenges facing Western democracies and authoritarian regimes regarding their participation in the globalized financial system.

Scholarly investigations into the roots of institutional success and failure of post-communist transformations contain an unintended and frequently unnoticed analytical bias. The analyses of successful cases of institutional transformation often highlight the role of international factors as crucial explanatory variables of achievement. For example, the idea of EU leverage in transforming institutions in countries that became EU members has been widely acknowledged and integrated into the mainstream understanding of successful transitions.¹ The idea of geographical linkages and diffusion of "good things" from the West has

¹Milada Anna Vachudova. 2005. *Europe undivided: democracy, leverage, and integration after communism*. Oxford: Oxford University Press.

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been also deemed an important element of the democratization process.² Explanations of failures, on the other hand, rarely probe into international factors and tend to focus on domestic causation. The body of literature emphasizing the role of domestic factors in democratic and governance failures is rich, theoretically innovative and geographically diverse.³ But the discussion of how international or transnational factors could become part of “vicious cycles” in institutional transformation is only at its inception. Fortunately, this state of affairs is starting to change. The empirical research Karen Dawisha conducted while writing *Putin's Kleptocracy* works to open this discussion by bringing to the table crucial data about the international linkages and dependencies of Russia's top political and economic elites.

The most recent revelations from the Panama Papers also work to shift the frame of reference with regard to the argued importance of linkages with the West for successful institutional transformation through learning, cultural transmission, and other elite and society-level changes.⁴ On the contrary, an exploration of such factors as the degree of elite integration into the global economy and finance opens new avenues for comprehending the roots of institutional failure in some post-communist countries as well as other nations that might be attempting to improve their weak institutions in the context of unprecedented globalization of national economies and financial structures. Indeed, the new revelations about the role of global financial institutions position the west as nothing less than a facilitator of modern-day corruption.⁵

The Panama Papers are just the latest confirmation of the extent to which tax avoidance and money laundering have become widespread around the world. Before the Panama Papers were the Luxembourg leaks; before the Luxembourg leaks, there was a Cyprus financial crisis that exposed tax evasion through Cypriot banks; still earlier was the Bank of New York scandal exposing money laundering from Russia; and even before that was FIMACO, a Jersey firm used by the KGB to funnel the

²Steven Levitsky and Lucan A. Way. 2006. “Linkage versus leverage. Rethinking the international dimension of regime change.” *Comparative Politics*, 38:4 (July): 379-400. Valerie J. Bunce and Sharon L. Wolchik. 2010. “Defeating dictators: Electoral change and stability in competitive authoritarian regimes.” *World Politics* 62:1 (January): 43-86.

³To cite just a few notable examples here: Lucan Way. 2015. *Pluralism by default: Weak autocrats and the rise of competitive politics*. Baltimore, MD: Johns Hopkins University Press; Henry E. Hale. 2014. *Patronal politics: Eurasian regime dynamics in comparative perspective*. Cambridge: Cambridge University Press. Steven M. Fish. 2005. *Democracy derailed in Russia: The failure of open politics*. Cambridge: Cambridge University Press.

⁴Levitsky and Way, 2006

⁵Aditya Chakraborty. 2016. “Corruption can no longer be dismissed as a developing world problem.” *The Guardian*, May 10. Accessed at: www.theguardian.com/commentisfree/2016/may/10/corruption-developing-world-problem-london-summit-panama-papers

Soviet Union's Communist party funds abroad.⁶ Additionally, there were numerous other cases related to the assets stolen by corrupt leaders such as Ferdinand Marcos (Philippines), Vladimir Montesinos (Peru), Sani Abacha (Nigeria), and Diepreye Alamiyeseigha (South Africa).⁷ In all these cases, the assets were hidden abroad – stashed away using foreign banks, offshore investment firms and lucrative real estate. Presently, almost every day we learn that the big Western corporations, banks, and investment companies, as well as the rich upper strata in the developing world, have been skillfully employing offshore financial zones to hide from taxes, state authorities, and potential raiders, sometimes using these financial institutions to launder proceeds from corruption and hide illicit profits by moving them into jurisdictions where the owners are given anonymity and non-transparency. Undoubtedly, the growing evidence of such behavior has raised some uncomfortable questions about the ethical standards underpinning the global financial order, the eroding social contracts sustaining state-society relations in the Western countries and the role of these transnational actors and mechanisms in supporting corruption and theft in the developing countries. It emerges that the Western financial institutions – not only in the notorious island-nations of Cyprus, British Virgin Islands or Bahamas, but in London, New York and Los Angeles – serve as a pillar of the system, linking corrupt, rent-based economies integrated into the global economy and developed countries with strong protection of property rights, competitive political systems and social prosperity.

I had the privilege of developing with Dr. Dawisha the analytical outlines of this argument in a co-authored article, “The Escape from Institution-Building in a Globalized World: Lessons from Russia” (forthcoming in *Perspectives on Politics*). In this essay, I will summarize our argument that Russian asset-holders used practices of institutional arbitrage to make profits in Russia and secure their assets abroad, thus essentially avoiding the issue of domestic institutional reforms. I will support this argument based on the most recent data that has emerged since our manuscript was submitted for publication.

Additionally, I will explore central policy dilemmas the Russian

⁶For documents associated with Luxembourg leaks, see: <http://cloudfront-files1.publicintegrity.org/apps/2014/12/luxleaks/index.html>; on Cyprus financial crisis, see Ned Resnikoff, “Cyprus disaster shines light on global tax havens,” *MSNBC*. Accessed at: www.msnbc.com/the-ed-show/cyprus-disaster-shines-light-global-tax-ha; on Bank of New York scandal, see Timothy L. O'Brien, “Bank Settles U.S. Inquiry into Money Laundering,” *New York Times* November 9, 2005. Accessed at: www.nytimes.com/2005/11/09/business/bank-settles-us-inquiry-into-money-laundering.html?_r=0; for the discussion of FIMACO, see Karen Dawisha. 2015. *Putin's Kleptocracy Who Owns Russia?* New York: Simon and Schuster.

⁷Some of these assets were recovered through StAR – Stolen Asset Recovery Initiative by the World Bank and the UNODC (<http://star.worldbank.org/star/>)

government – and, arguably, other authoritarian regimes – has to face in relation to its globalized elites, as well as Western governments' policy dilemmas as they confront the growing realization that the global financial industry (dominated by Western economic actors) is being widely discredited by the practices of money-laundering and tax evasion: providing a shelter for dirty cash to dictators and corrupt elites from the developing countries, and assisting global corporations to circumvent domestic tax rules and regulations. I argue that these policy challenges vary across regime types and that forcing Western financial institutions to clean up their act appears more likely than restraining economic actors from countries with unaccountable governments.

Offshoring Wealth, Offshoring Loyalties

Whether a regime is democratic or authoritarian, there is an evident conflict of public and private interests with regard to the opportunities provided by the global financial institutions. While the rich and powerful in both types of regime might be interested in securing their assets or avoiding higher taxes, in democracies, tax evasion goes against the basic social contract underpinning the operation of the state and the government. Therefore, as the public pressure on state officials increases, we could expect more policy initiatives designed to rein in financial abuse. Such policy initiatives are already underway and we can expect gradual change and closing of loopholes used by multinational corporations (since the process of learning about the effectiveness of particular measures takes time). Thus, the synergy between growing public awareness and the regulatory changes promoted by the governmental and non-governmental agencies provides some hope that the culture of tax evasion by global corporations might be curtailed in the West.

In authoritarian systems, on the other hand, the government is interested in greater control over – and assuring the loyalty of – domestic elites, and is therefore opposed to institutional exit strategies enabled by foreign financial institutions and widely employed by domestic elites. The actions of domestic elites in such systems are, driven not only by the logic of profit-maximization (as in the case of Western firms evading taxes) but also by the defensive logic of asset securitization in the absence of domestic institutions protecting property rights. The demand for institutional escape is, arguably, even stronger than the logic of tax optimization and is manifested in the actions of top government leaders in countries like Russia, China, Kazakhstan and other relatively rich but non-democratic nations. Given the functional significance of foreign financial institutions for businesses in countries with weak institutions, it is not likely that the governments would follow through in their publicly declared de-offshoring campaigns

because it would mean increased capital flight and potential economic disaster. Furthermore, as illustrated by the case of Russia, corruption appears so routinized and normalized in some of these countries that even large scale, public revelations about top officials' assets hidden abroad do not result in public outcry and pressure on the government. Therefore, the institutional exit strategies used by economic actors in such states are likely to continue, further entrenching these nations in an institutional trap whereby the ineffectiveness of domestic institutions, especially those concerned with property rights protection, is compensated for by foreign institutions.

In our study with Karen Dawisha, we use the term "institutional arbitrage" to capture these practices and highlight their institutional implications. Institutional arbitrage refers to economic actors' strategic use of institutions in different jurisdictions to meet their institutional needs at different points. In Russia, for example, economic actors take advantage of the weak institutional environment to make super-profits, often relying on informal connections and corruption. Weak institutions and a corrupt rule-of-law system cannot protect economic assets well, however. So when assets need to be protected, Russian asset-holders find solutions abroad, in countries with strong traditions of the rule of law, impartial judiciary and reliable law enforcement institutions.

The source of wealth creation is not really significant when it comes to institutional arbitrage practices. Whether businesses have relied on their personal connections or not, whether they have broken the law or have only used legal loopholes, having obtained their wealth, they all find themselves in a similar institutional environment, characterized by legal uncertainty and the potential threat of expropriation by the private or public sector. The use of other available means of securing property rights is a logical strategy in such conditions.

Karen Dawisha's research brings to the forefront the idea that the strategy of securing funds abroad is not entirely new. Their origin dates to the management of the Soviet state reserves and the Communist Party of the Soviet Union (CPSU) funds to which insider KGB and CPSU elites were allowed privileged access.⁸ With the growing political uncertainty and destabilization resulting from Gorbachev's reforms, the insider party elites wanted to secure their future in case of the Soviet collapse and set up numerous offshore bank accounts, foreign companies, and real estate holdings that, according to one estimate, amounted to \$50 billion of hidden assets.⁹ In her book, Dawisha also brings attention to Vladimir Putin's activities in St. Petersburg in the 1990s, where, within a close circle of friends and as a head of the Committee for Foreign Liaison in the city

⁸Dawisha, 2015, 20-21.

⁹Dawisha, 2015, 18-19.

government, he was well positioned to become a mediator enabling local profit-making and securitization of assets abroad through Western financial and legal institutions.¹⁰

Institutional arbitrage strategies developed further in the 1990s and became especially widespread in the 2000s, as foreign solutions became less costly and more available even to small and medium-size firms and companies and to regional and local-level state officials and politicians.¹¹ One estimate pointed out that between 70-90 percent of Russian companies formally belong to entities registered in offshore zones.¹² The massive capital flight from Russia in the last quarter of the century is perhaps the clearest indicator of nascent Russian capitalists voting “with their feet” in response to political instability and insecure property rights in the new Russia. According to some estimates, 50 percent of Russian capital is hidden offshore.¹³ The most recent estimate by the Tax Justice Network, a UK-based advocacy group concerned with tax avoidance issues, shows that by the end of 2014 \$1.3 trillion of assets from Russia were “sitting abroad.”¹⁴ Some Russian estimates of capital outflows from the country amounted to \$2 trillion.¹⁵ The emergence, in the 2000s, of the phenomenon of “round-trip” investors, who first transferred funds abroad and then brought them back into the country as foreign investments, was an important indicator of the growing dynamism of the Russian economy and the expansion of profit-making opportunities, especially for those well-connected with the government at various levels.¹⁶ But Russian capitalists’ reaction to Putin’s new adventures in foreign policy have also been revealing – when the shift began in 2014, Russia experienced an exodus of capital, with over \$154 billion leaving the country in one year.¹⁷

¹⁰Dawisha, 2015, chapter 2.

¹¹Mark H. Gay. 2013. “Havens Retain Allure For Firms Seeking Flexibility Offshore,” *The Moscow Times* May 15. Accessed at: www.themoscowtimes.com/business/article/havens-retain-allure-for-firms-seeking-flexibility-offshore/480057.html

¹²Boris A. Kheyfets. 2010. “Antiofshornoe nastuplenie mirovogo soobshchestva i rossiyskaia politika,” *Finansy i biudzhety: Problemy i reshenia*. No. 2: 15. Accessed at: www.imepi-eurasia.ru/baner/finance.pdf

¹³Brooke Harrington, ““Rodnye ofshory.” *The Esquire*. Accessed at: esquire.ru/brooke-harrington

¹⁴Heather Stewart. 2016. “Offshore finance: more than \$12tn. siphoned out of emerging countries,” *The Guardian*, May 8. Accessed at: www.theguardian.com/business/2016/may/08/offshore-finance-emerging-countries-russia-david-cameron-summit

¹⁵“Capital flight from Russia halves in 2015 – Central Bank.” *RT*. Accessed at: www.rt.com/business/321547-russia-capital-flight-drop/

¹⁶Svetlana Ledyayeva, Päivi Karhunen, and John Whalley. 2013. “If Foreign Investment is not Foreign: Round-Trip Versus Genuine Foreign Investment in Russia.” No. 2013-05. Accessed at: tippie.uiowa.edu/economics/tow/papers/ledyaeva-spring2013.pdf

¹⁷“Russia: Massive capital flight continues,” 2015. *Moscow Times*. May 1. Accessed at: www.themoscowtimes.com/business/article/russia-massive-capital-flight-continues/520112.html

With rising public pressure and international criticism of offshore banking and finance, and the promotion of new rules against money laundering activities that have changed the ways banks operated in the past, asset holders who needed to hide their proceeds found another way.¹⁸ In the last few years, prime real estate markets in New York, London, Los Angeles, Miami and other attractive destinations have experienced an inflow of foreign capital, usually from secretive shell companies which hide the identities of those behind these purchases.¹⁹ A recent investigation into the condo owners in the Time Warner Center overlooking Central Park in Manhattan by journalists from *The New York Times* revealed a growing proportion of foreign owners, with at least 16 of them subject to government inquiries for various types of violations. Among these owners are foreign officials from Russia, Kazakhstan, China, Malaysia, and Mexico.²⁰ The prime real estate market in London is similarly dominated by wealthy foreigners, with a particularly large share of Russian buyers.²¹

The widespread reliance on foreign law in contract-writing and foreign courts in dispute resolution is another significant feature of institutional arbitrage. Specifically, the UK High Court, London Court of International Arbitration, the Arbitration Institute of the Stockholm Chamber of Commerce and the High Court in Singapore have become important destinations for post-Soviet businessmen seeking an impartial legal system. Besides the most notorious court cases – such as the one between Boris Berezovsky and Roman Abramovich in 2012 – there are many others, smaller in scale, involving claimants from Russia and other post-Soviet countries. According to one estimate, 63 percent of cases heard in English courts between March 2014 and March 2015 were brought by overseas claimants.²² Portland Legal Disputes, an international law firm, analyzed High Court rulings between 2013 and 2014; they found that litigants from Russia were second only to those from the United States, and were followed by claimants and defendants from Kazakhstan.²³

¹⁸On the evolution of the AML regime, see for example, Peter Reuter and Edwin M. Truman. 2004. *Chasing Dirty Money*. Washington DC: Peterson Institute for International Economics.

¹⁹Louise Story and Stephanie Saul. 2015. "Towers of Secrecy: Stream of Foreign Wealth Flows to Elite New York Real Estate," *New York Times*, February 7. Accessed at: www.nytimes.com/2015/02/08/nyregion/stream-of-foreign-wealth-flows-to-time-warner-condos.html?ref=collection%2Fnewseventcollection%2Fshell-company-towers-of-secrecy-real-estate&action=click&contentCollection=us®ion=rank&module=package&version=highlights&contentPlacement=1&pgtype=collection&_r=0

²⁰Story and Saul, *Towers of Secrecy*.

²¹Ed Caesar. 2015. "House of Secrets," *New Yorker* June 1. Accessed at: www.newyorker.com/magazine/2015/06/01/house-of-secrets

²²Jane Croft. 2015. "Number of UK litigants fighting disputes in High Court rebounds," *The Financial Times*, July 19. Accessed at: www.ft.com/cms/s/0/91836d22-2bd5-11e5-acfb-cb-d2e1c81cca.html#axzz48MXA2z4w

²³Jane Croft, Jane. 2014. "Three Quarters of Litigants in UK commercial court are foreign,"

In short, Russian capitalists are essentially global and, more often than not, Western-based, with their families' futures planned outside Russia. These trends hold at the top echelons of power and wealth in Russia, at the middle echelons and even, to a certain extent, at the bottom, or local, level, where those with access to power and wealth turn to foreign institutions to securitize their assets and future. It is ironic and revealing that Artem Chaika, the elder son of the prosecutor general Yuri Chaika, the state official at the helm of the rule of law system in Russia, clearly sees his future as being in the West. His Swiss residency permit and a big villa in Switzerland, recently brought to public attention by Navalny's Foundation for Fighting Corruption (FBK) investigation, clearly indicates that making money in Russia does not mean living in Russia.²⁴ The story of Artem Chaika is representative of many other children of the present Russian elite. The family of Vladimir Yakunin, ex-manager of Russian Railways (RZhD) is another case in point. Yakunin, Putin's close associate from the 1990s in St. Petersburg, lost his position in RZhD in 2015, allegedly due to his son's application for British citizenship.²⁵ Even if there were an alternative explanation for Yakunin's demise, his son's choice is suggestive of elite preferences and visions for the future.

At first glance, these elite preferences might not seem problematic. Indeed, they mesh with global trends and options open to other capital-holders around the world. After all, businesses are meant to make money, secure it and then, hopefully, invest back into the economy. Why should we care about the availability of such arbitrage opportunities to economic actors? The problems arise when one considers the institutional implications of such opportunities for nations experiencing "capital flight." The mainstream analysis of institutional evolution in established democracies has pointed to the crucial role of property owners in lobbying the government for strong institutions.²⁶ In older democracies, major asset-holders (whether land owners in England, bourgeoisie in France) have been essential to limiting the government and establishing credible commitment.²⁷ The idea of private owners becoming champions of democ-

The Financial Times, May 29. Accessed at: www.ft.com/intl/cms/s/0/4c33f0c0-e716-11e3-88be-00144feabdc0.html#axzz3NDmTEx3R

²⁴Alexei Navalny's Anti-Corruption Foundation investigation. Accessed at: <https://fbk.info/search/?q=%23%D1%87%D0%B0%D0%B9%D0%BA%D0%B0>

²⁵Eva Hartog. 2015. "Yakunin Quit Russian Railways Over Son's Wish to Become British Citizen," *Moscow Times* October 11. Accessed at: www.themoscowtimes.com/business/article/yakunin-quit-russian-railways-over-sons-wish-to-become-british-citizen--report/538362.html

²⁶For a classical statement of this argument, see Douglass C. North and Barry R. Weingast. 1989. "Constitutions and commitment: the evolution of institutions governing public choice in seventeenth-century England." *The journal of economic history* 49.04: 803-832.

²⁷*Ibid.*

ratization and institution-building was also foundational to reform efforts in the post-communist regions. Yet the anticipated collective action of elites was nowhere to be found. Instead, many nations were caught in a “partial reform equilibrium,” with early winners inhibiting institution-building and weakening nascent democratic systems.²⁸ If these winners can take advantage of weak institutions and use foreign jurisdictions to securitize their assets, then the problems for institution-building become much more evident. Post-communist economic actors simply operate within a set of incentives provided to them by the global and domestic economies.

The absence of elites that can pressure the government to improve institutional environment results in institutional degradation and facilitates an adverse selection process that enables asset-holders with strong political connections to structure the rules of the game to their benefit. The resulting economic concentration and monopolization, along with economic inefficiencies and undermined consumer interests, are among the negative consequences of such selection.

Revealingly, Vladislav Surkov, the deputy chief of presidential administration and Putin’s political demiurge in the first decade of the 2000s, noted once that Russia’s main problem is the absence of *nationally-minded* elites. He argued that the contemporary Russian ruling elite is more of an “offshore aristocracy” that deems Russia a “free hunting zone.” The members of this social group live abroad, educate their kids abroad, and treat Russia as a place from which they can extract profits, while their lives and aspirations are elsewhere.²⁹ It could be added that contemporary economic elites in Russia are those with the closest links to the state. Another recent revelation is concerned with thousands of valuable real estate items around Moscow that belong to offshore companies. The journalists working for *New Times* revealed that 1,226 offshore companies own 6,743 pieces of real estate around Russia’s capital. Some of that real estate was formerly under the institutional control of the KGB/FSB as well as government *dachas* and resort palaces under the control of the Soviet Council of Ministers and other governmental agencies.³⁰

It is important to recognize that there are exceptions to this pattern and some Russian capitalists are undoubtedly more civic-minded, more committed to the country’s future, and more prone to lobbying for a more effective government and secure property rights than others. When Alexey

²⁸Joel S. Hellman. 1998. “Winners take all: the politics of partial reform in postcommunist transitions.” *World politics* 50.02: 203-234.

²⁹Vladislav Surkov. 2006. “Suverenitet eto politicheskii sinonim konkurentosposobnosti,” speech at meeting of United Russia party school, February 7, 2006. Accessed at: <http://www.politnauka.org/library/public/surkov.php>

³⁰“Rassledovanie New Times raskrylo tysiachi peredannykh ofshoram podmoskovnykh uchastkov,” May 16, 2016. Accessed at: newsru.com/russia/16may2016/ntinvestigation.html

Navalny ran in the 2013 Moscow mayoral elections, a group of businessmen supported his bid and funded his Foundation for Fighting Corruption, openly challenging the Kremlin and the political establishment.³¹ Yet these exceptions do not negate the dominant trend of Russia's big businesses staying silent, not interfering in politics and not challenging the Kremlin and its rules openly. Institutional arbitrage appears as a safer and less costly choice for the majority of Russian capitalists.

The issue of Russian elite loyalties has come under some scrutiny in the last few years. Vladimir Putin himself, when asked about his daughters, has highlighted that they have been educated in Russia and continue to work and live there.³² Yet we also know now, as a result of a recent Reuters investigation (later expanded by RosBusinessConsulting – RBC Group journalists) that his daughters and their families belong to the privileged few, with high-value foreign property and other assets secured outside Russia.³³ The sensitivity of this issue was highlighted when the senior managers of RBC Group were fired in May 2016, allegedly in response to publications about Putin's palace in Gelendzhik, as well as the earlier publications about his family, particularly his son-in-law, Kirill Shamalov.³⁴

Globalization and Authoritarian Regimes' Predicament

The practices of institutional arbitrage described above using the case of Russia are widespread in other parts of the world. Besides other post-Soviet countries, such as Kazakhstan and Ukraine, and even the poorer states in Central Asia that witnessed the proliferation of these strategies, other developing nations face the same predicament.³⁵ China is another great illustration of a country whose elites are increasingly vested abroad and whose government has repeatedly initiated anti-corruption campaigns, seeking ways to control offshorization processes and even hunting assets

³¹Irina Filatova, 2013. 37 Businessmen Challenge Kremlin by Openly Backing Navalny." *Moscow Times*. August 7. Accessed at: www.themoscowtimes.com/business/article/35-businessmen-openly-support-navalny/484204.html

³²"Putin o docheriakh.." December 17, 2015. *TASS*. Accessed at: tass.ru/obschestvo/2537093

³³Stephen Grey, Andrey Kuzmin, and Elizabeth Piper. 2015. "Comrade Capitalism: How Russia Does Business in the Putin Era," Reuters, November 10. Accessed at: www.reuters.com/investigates/special-report/russia-capitalism-daughters/. Irina Malkova and Sergei Titov. 2015. "Semeinye tsennosti." December 18. Accessed at: <http://www.rbc.ru/society/18/12/2015/56bc89e79a7947299f72b745>

³⁴Anyar Ardayeva. 2016. "Three Top Managers Leave Russia's RBC Media." *Moscow Times*, May 13. Accessed at: www.themoscowtimes.com/news/article/three-top-managers-leave-russias-rbc-media/569412.html. Natalia Rostova. 2016. "Could a union do anything to protect Russian journalists?" Accessed at: www.opendemocracy.net/od-russia/nataliya-rostova/could-trade-union-do-anything-to-protect-russian-journalists

³⁵Alexander Cooley and J. C. Sharman. 2015. "Blurring the line between licit and illicit: transnational corruption networks in Central Asia and beyond." *Central Asian Survey* 34.1: 11-28.

and individuals overseas.³⁶ Authoritarian regimes such as those of Russia, Kazakhstan and China have to balance their financial openness policies with concern for regime maintenance, domestic control and political and economic stability as well as control over their elites, who could presumably escape from domestic control and move their entire capital abroad, undermining the economies of these countries.

Scholars have long noted new political challenges arising out of financial internationalization and increased capital mobility. The dominant trend in this literature has been to highlight the changing power dynamic between the private actors and the state in favor of the private actors who now, allegedly, have a credible “exit” option and can demand a better business environment, lower taxes and better institutions, or else threaten the government with departure. Any government that normally depends on private investments for economic growth and development would therefore be more prone to cooperate with capital-holders capable of taking their capital elsewhere.³⁷ Carles Boix, for example, has argued that the capital flight curbs redistributive pressures, forces governments to lower taxes, and reduces political conflict among capital holders and nonholders, thereby increasing the likelihood of democracy.³⁸ Freeman and Quinn further developed this argument, showing that financially integrated autocracies are more likely to democratize.³⁹

Some scholars disagreed with these optimistic assessments. Cai and Treisman raised concerns about their unrealistic assumptions.⁴⁰ Logvinenko added to the debate by inquiring into authoritarian regimes’ choice for financial openness, linking it to the issue of regime survival and regime’s capacity to mitigate the effects of downside risks.⁴¹ Contrasting Russia’s financial openness with China’s more cautious and contradictory policies regarding financial flows, Logvinenko suggested that authoritarian regimes have to balance the costs and benefits of financial openness; their extent of redistributive capacity might be responsible for the degree to which they might be willing to integrate into global financial markets.

³⁶Juliette Garside and David Pegg. 2016. “Panama papers reveal offshore secrets of China’s red nobility.” *The Guardian*. April 6. Accessed at: www.theguardian.com/news/2016/apr/06/panama-papers-reveal-offshore-secrets-china-red-nobility-big-business

³⁷Robert H. Bates and Da-Hsiang Donald Lien. 1985. “A Note on Taxation, Development and Representative Government,” *Politics and Society* 14: 53-70.

³⁸Carles Boix. 2003. *Democracy and redistribution*. Cambridge: Cambridge University Press, 3.

³⁹John R. Freeman and Dennis P. Quinn. 2012. “The economic origins of democracy reconsidered.” *American Political Science Review* 106.01: 58-80.

⁴⁰Hongbin Cai and Daniel Treisman. 2005. “Does competition for capital discipline governments? Decentralization, globalization, and public policy.” *The American Economic Review* 95.3: 817-830.

⁴¹Igor Logvinenko. 2016. “Open Economies, Closed Politics: Financial Openness in Russia and China,” Paper prepared for the 2016 ISA meeting, March 16-19, Atlanta, USA.

Looking at Russia and China, Logvinenko argued that Russia's choice of financial integration was assisted by the presence of a massive, welfare-state-based redistributive capacity inherited from the Soviet era, which helps mitigate the effects of economic and financial crises that could otherwise prove fatal to the regime. Such capacity is not available in China, where the government has relied more on repressive than redistributive means of regime maintenance – hence, the Chinese government has been more cautious in reaping the benefits of financial integration.⁴²

The findings from our research with Karen Dawisha also run counter to the assessments that financial internationalization and integration empowers capital-holders vis-à-vis the state and increases the likelihood of democratization. In the case of Russia, financial internationalization evolved hand in hand with growing authoritarianism, an increasing use of repressive methods of political control, and reduced freedoms and liberties for the Russian population. Dawisha's *Putin's Kleptocracy*, in fact, leads to questioning the liberal model of capitalism that assumes separation of political and economic interests, and suggests that the choice for financial openness might have been linked to the private interests of those closest to power and profits, those who could take advantage of the weak institutional environment in Russia and were interested in securing their ill-gotten capital in safe havens. Indeed, as noted by many other scholars, Russia's post-Soviet capitalism (often dubbed "crony capitalism") is inherently political in nature and business ties to the state have been crucial for economic success.⁴³ Arguably, political connections have become even more consequential during Putin's presidency as the regime worked to curb political and economic competition. In May 2016, *The Economist* published the "crony capitalist index," placing Russia on top, far ahead of next-ranked Malaysia and Philippines, with Ukraine in 5th place.⁴⁴

Importantly, even while building authoritarian Russia and enhancing mechanisms of domestic political control, Putin expressed strong support for international economic integration and, in his first two terms in power, systematically followed that agenda. Russia negotiated joining the WTO,

⁴²Ibid. It is indicative that even in China following a more cautious approach to financial integration, the practices of institutional arbitrage appear popular as manifested in vast capital outflows and offshore property investments. Indeed, Chinese and Russian buyers are often competing in the global luxury real estate market.

⁴³For a structural argument about the origins of such capitalism, see Venelin Ganey. 2007. *Preying on the state: the transformation of Bulgaria after 1989*. Ithaca: Cornell University Press.

⁴⁴To produce this index *The Economist* used the measure of billionaire wealth as a percent of GDP, ranked by crony-sector wealth (with crony sectors including casinos, banking, energy, defense, utilities and telecoms, ports and airports, real estate and construction, infrastructure and pipelines, coal, timber and palm oil, steel and other metals). Accessed at: www.economist.com/blogs/graphicdetail/2016/05/daily-chart-2

lobbied for OECD membership, and took steps to comply with Financial Action Task Force (FATF) regulations. In his 2003 annual address to the Federal Assembly he argued, that

No country today, no matter how big and how wealthy, can develop successfully in isolation from the rest of the world. On the contrary, the biggest success comes to those countries that consciously use their energy and intelligence to integrate themselves into the world economy.⁴⁵

Supported by high prices for oil and gas, the Russian economy benefitted from foreign trade, foreign investments (though many of these were “round-trip” investments) and access to global financial markets. This pro-integration stance remained strong even after the 2008 financial crisis that resulted in Russia’s economy contracting more than that of any other G20 country.⁴⁶

The dominant pro-globalization discourse shifted around 2012 with Putin’s third presidential term. The new, anti-globalization turn was vocalized by Vladimir Yakunin, Putin’s old friend, who actively promoted anti-Western conspiracy theories and, in 2015, denounced globalization and particularly the global financial system as “a tool of the global financial oligarchy to rob developing nations and create a system of global U.S. dominance.”⁴⁷ Policy-wise, the government’s attention was focused on the issue of offshorization of the Russian economy. In his 2012 annual address to the Federal Assembly, Putin launched a de-offshorization campaign banning government officials from holding financial assets abroad and pointing to the “need [for] a comprehensive system of measures to reverse the offshoring of our economy.”⁴⁸ He complained that Russian businesses conduct their transactions under foreign, not Russian law, calling to improve “the improper elements in our own judicial system, in our law-making, in our law enforcement practices.”⁴⁹ These rhetorical statements were later bolstered by a new “de-offshorization” law that introduced a concept of a controlled foreign company (CFC) and obliged all Russian tax residents (individuals or companies) holding more than 10 percent in CFCs (any trusts, partnerships, foreign corporations and funds) to declare and, starting in 2015, pay taxes on their income.⁵⁰

⁴⁵Vladimir Putin. 2003. “Annual Address to the Federal Assembly of the Russian Federation.” Accessed at: en.kremlin.ru/events/president/transcripts/21998

⁴⁶Nigel Gould-Davies. 2016. “Russia’s sovereign globalization: rise, fall and future,” 16-17. Accessed at: <https://www.chathamhouse.org/sites/files/chathamhouse/publications/research/20160106RussiasSovereignGlobalizationGouldDaviesFinal.pdf>

⁴⁷Vladimir Yakunin. 2015. “Globalizatsiia i kapitalizm.” *Razvitie i ekonomika* #13, July. Accessed at: devec.ru/almanah/13/1846-vladimir-jakunin-globalizatsija-i-kapitalizm.html

⁴⁸Gould-Davies

⁴⁹Vladimir Putin. 2012. “Annual Address to the Federal Assembly of the Russian Federation.” Accessed at: en.kremlin.ru/events/president/news/50864

⁵⁰“CFC rules: towards the deoffshorisation of the Russian economy?” Accessed at: www.

In an additional move to repatriate capital taken abroad in the last two decades, the Russian government adopted in 2015 a new “capital amnesty” law that promised a “free pass” on a range of legal, tax and administrative violations to businesses declaring their foreign assets to Russian authorities. However, this law did not produce the reaction expected; there are few cases of companies or individuals who used this law and registered their holdings in Russia.⁵¹ Most analysts noted that the main requirement for the law to work – a degree of trust that the government can credibly commit to its promises – is absent. The government instead focused on more technical issues that might be hindering the law’s effectiveness, introducing amendments to the CFC law and extending the capital amnesty until July 1, 2016.

These recently-initiated policies show that the Russian government seems to be starting to act on the problems of offshores and tax avoidance. The low oil prices and foreign sanctions that deprived the Russian businesses of the access to foreign capital markets have created powerful incentives to work in this direction. Yet the effectiveness of these measures and the rhetoric appears highly questionable. From numerous informational leaks, we have learned that even those closest to Putin hide their assets in offshore accounts and jurisdictions. Recently, Putin’s friend Sergei Roldugin – himself linked to massive offshore accounts – was dubbed a “secret caretaker” of Putin’s own fortunes.⁵² It is unrealistic to anticipate that this trend is likely to change any time soon given that those closest to Russia’s president are the worst offenders.

In short, even when globalization is seen as a threat to state sovereignty and political stability and when anti-globalization discourse is used for ideological purposes, authoritarian regimes, at least in the case of Russia, could stay closely linked to international financial and legal structures. These linkages are mostly at the level of rich individuals and private firms that rely on foreign institutions to safeguard the capital usually extracted from the domestic economy and society, often through illegal means. The growing realization of this “dark side” of global finance – sparked by increasing evidence, most recently from the Panama Papers

financierworldwide.com/cfc-rules-towards-the-deoffshorisation-of-the-russian-economy/#.VztIDGaMF-w

“New Russian ‘anti-offshore’ law means changes for Russian treaties and real estate owners,” *PWC*. November 20, 2014. Accessed at: www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-russian-anti-offshore-law-changes-russian-treaties.pdf

⁵¹According to experts, only around 200 people have used this law in 2015. See “Amnistiia kapitala budet usovershenstvovana i prodlena – deputat Gosdumy ot Voronezhskoi oblasti.” December 21, 2015. Accessed at: abireg.ru/n_50911.html

⁵²Roman Anin, Olesya Shmagun, and Dmitry Velikovskiy, “Panama Papers: The Secret Caretaker.” Accessed at: www.occrp.org/en/panamapapers/the-secret-caretaker/

leakage, and growing public attention to these issues – will undoubtedly raise the need for policy actions on the part of Western democracies implicated in being a conduit for illicit funds. But how has the reaction of Western governments been so far?

Offshores and Western Democratic Dilemmas

The growing revelations about tax avoidance through offshore financial zones have become politically important for Western countries in at least two ways. On the one hand, the extent of these practices and the involvement of top government officials work to undermine the very basis of the social contract linking the state and society in the West. After all, paying taxes in exchange for public goods provision is the cornerstone of the liberal vision of the state. If top state officials, global corporations or other wealthy economic actors can exit this contract, hiding their assets or optimizing their taxes by shifting profits to low- or no-tax locations and leaving the rest of the society to pay for the state, the very foundations of the democratic system appear undermined and the social contract discredited. Quick resignations of top officials in Iceland and Spain in the aftermath of the Panama Papers scandal and calls for resignation in Pakistan as well as the pressure exerted on British prime minister David Cameron all suggest that officials will be held responsible, at least in democratic and politically competitive systems of governance. These pressures will necessitate additional policy response on the part of the Western governments to regulate and potentially restrict the special economic zones offering opportunities for tax avoidance.

The second important revelation from the recent Panama leaks concerns the issue of corruption. More often than not, corruption has been seen as something that afflicts the non-Western, poor countries. When it happens in the West, it is more of an exception, with perpetrators held accountable for their actions and the system reformed to deal with existing loopholes. The ever more evident role of offshores in illicit financial flows, however, has highlighted the supply side of corruption: there are thousands of lawyers, bankers, corporate officials, real estate agents and other economic actors in the West who benefit from the widespread practices of securing assets in special financial zones that provide secrecy and anonymity to their account holders. The Western financial institutions work to enable and facilitate these flows and, arguably, the extent of corruption afflicting the developing countries is partially linked to these new opportunities for hiding wealth abroad. This point was vocalized by the Nigerian president Muhammadu Buhari at the recent May 2016 Global Anti-Corruption Summit in London, where he suggested that corruption is “a hydra-headed monster. It does not differentiate between developed and

developing countries.”⁵³ Indeed, the Nigerian government has long been working to repatriate from the West the assets stolen by Sani Abacha and is keenly aware of the difficulties and costliness of this process.⁵⁴ At the Global Anti-Corruption Summit itself, Western public officials openly admitted the global nature of corruption for the first time and expressed openness to considering the role of the West in these processes.

Nonetheless, this most recent outcry related to tax avoidance through offshore jurisdictions has been just one event in a string of similar revelations. The Western countries, and particularly those that occupy the more dominant positions in the global financial markets – the United States, the United Kingdom, and Switzerland – have become keenly aware of the necessity of ensuring the integrity of the global financial system, especially in the face of widespread manipulation and abuse of the system for money-laundering and tax evasion purposes. In response to such financial crimes, Western governments, along with international organizations, such as the World Bank, the OECD and the IMF, have initiated a new body of laws and regulations now known as anti-money laundering (AML) rules. These rules began with the adoption in the United States of the Bank Secrecy Act (1970) and Money Laundering Control Act (1986), and have since been enhanced by numerous other domestic and international rules and regulations dealing with financial crimes. The more recent concerns for terrorism financing have added political weight to such legislation. The body of rules aimed at countering financial abuse is now referred to as the International Framework for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).⁵⁵

Starting in 2013, the developed countries articulated a new policy issue, bringing attention to international tax evasion by multinational corporations and referring to “base erosion and profit-shifting” (BEPS) – defined as “tax planning strategies that exploit these gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations, where there is little or no economic activity, resulting in little or no overall corporate tax being paid.”⁵⁶ The OECD has prepared a final BEPS package of reforms of the international tax system that included fifteen “actions” designed to deal with various aspects of international tax avoidance.⁵⁷ In

⁵³The full text of his speech can be accessed here: www.opengovpartnership.org/blog/ogp-webmaster/2016/05/11/full-text-buhari's-speech-anti-corruption-summit-london

⁵⁴Morgan Winsor. 2016. “Nigeria, Switzerland Agree On Returning \$321 M in Stolen Abacha Funds,” March 9, 2016. Accessed at: ibtimes.com/nigeria-switzerland-agree-returning-321m-stolen-abacha-funds-2333157

⁵⁵See IMF, “Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT). Accessed at: <https://www.imf.org/external/np/leg/amlcft/eng/>

⁵⁶See OECD, “About BEPS and the inclusive framework.” Accessed at: <http://www.oecd.org/ctp/beps-about.htm>

⁵⁷Final reports can be accessed here: www.oecd.org/ctp/aggressive/beps-2015-final-reports.

2016, the OECD countries have agreed that all interested countries and jurisdictions can join these efforts and the new “Platform for Collaboration on Tax” was announced in April 2016, with the first meeting of the BEPS framework planned for June 2016, in Kyoto, Japan.

In short, the Western governments, supported by international organizations such as the World Bank and the OECD, do seem to have intensified their efforts in changing the rules of the system so as to curtail the practices of financial abuse. Given the history of these efforts, however, it is clear that no immediate and dramatic changes are likely. At the same time, growing public awareness and continuous public pressure in relation to these challenges appear very important both for continuing governmental policy efforts and, crucially, for a gradual shift in the norms underpinning the practices of global corporations. The extent to which the policy changes discussed above will deal with the problem of corruption originating in developing countries and facilitated by Western actors and institutions is also questionable. The likelihood of more positive changes in authoritarian regimes arguably depends more on domestic political mobilization and action. Unfortunately, the piecemeal approach to reforming the global financial system (perhaps the only approach possible without bringing the system to a halt) led by advanced industrialized democracies will not remove the institutional “exit” option from the strategies available to domestic elites in authoritarian states, thus diminishing the likelihood that they will express a preference for “voice” through political action.⁵⁸

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⁵⁸For the explicit application of Albert Hirschman’s ideas of exit and voice from his 1970. *Exit, voice and loyalty: Responses to decline in firms, organizations, and states*. Vol. 25. Cambridge, MA: Harvard University Press, see Gulnaz Sharafutdinova and Karen Dawisha, “The Escape from Institution-Building in a Globalized World: Lessons from Russia,” *Perspectives on Politics*, forthcoming.